

Rochester Tel Center  
180 South Clinton Avenue  
Rochester, New York 14646-0700

716-777-1028

Michael J. Shortley, III  
Senior Corporate Attorney

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BY OVERNIGHT MAIL

William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, N.W.  
Washington, D.C. 20554

Re: CC Docket No. 93-193

Dear Mr. Caton:

Enclosed for filing please find an original plus seven (7) copies of the Direct Case of Rochester Telephone Corporation in the above-docketed proceeding.

To acknowledge receipt, please affix an appropriate notation to the copy of this letter provided herewith for that purpose and return same to the undersigned in the enclosed self-addressed envelope.

Very truly yours,

*Michael J. Shortley* (cm)

Michael J. Shortley, III

cc: ITS, Inc.

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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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In the Matter of )  
)  
)

1993 Annual Access Tariff Filings )

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CC Docket # 8-193

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1993 Annual Access Tariff Filings )  
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CC Docket No. 93-193

DIRECT CASE OF ROCHESTER  
TELEPHONE CORPORATION

Introduction and Summary

Rochester Telephone Corporation ("Rochester") hereby submits its direct case in response to the Designation Order in this proceeding.<sup>1/</sup> The Commission has designated eight issues for investigation -- two of which directly affect Rochester:

1. Have the LECs borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the TBO amounts under the Commission's price cap rules?<sup>2/</sup>
2. Have LECs properly reallocated GSF costs in accordance with the GSF Order?<sup>3/</sup>

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<sup>1/</sup> 1993 Annual Access Tariff Filings, CC Dkt. 93-193, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, DA 93-762 (released June 23, 1993) ("Designation Order").

<sup>2/</sup> Id., ¶ 105 (issue 1).

<sup>3/</sup> Id. (issue 6).

In addition, the Commission has requested comment on the manner in which price cap exchange carriers should calculate their low end or sharing amounts. Id. (issue 2). As a price cap carrier, Rochester has a direct interest in this issue. However, the Commission has commenced a rulemaking proceeding addressed to this issue. Price Cap Regulation of Local Exchange Carriers - Rate of Return Sharing and Lower Formula Adjustment, CC Dkt. 93-179, Notice of Proposed Rulemaking, FCC 93-325 (released July 6, 1993). Rochester will submit its comments on this issue in the rulemaking.

In this direct case, Rochester will demonstrate that:  
(a) it has met its burden of showing that the portion of its expense of implementing Statement of Financial Accounting Standard 106 ("SFAS 106") attributable to the Transition Benefit Obligation ("TBO") and associated accrued interest qualifies for exogenous cost treatment under the price cap rules; and (b) it reallocated its General Support Facilities ("GSF") costs in accordance with the GSF Order.<sup>4/</sup>

1. SFAS 106 Expense

In the Designation Order, the Bureau continues to express concern that exchange carriers have not adequately addressed certain alleged double-counting issues -- anticipation of SFAS 106 in the currently authorized rate of return; the effect of SFAS 106 expense on establishing the productivity offsets; and intertemporal effects.<sup>5/</sup> The claims that these alleged sources of double-counting exist lack merit.

First, the pendency of the accounting change contained in SFAS 106 could only have affected the prescribed rate of return

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<sup>4/</sup> Amendment of the Part 69 Allocation of General Support Facility Costs, CC Dkt. 92-222, Report and Order, FCC 93-238 (released May 19, 1993) ("GSF Order").

<sup>5/</sup> Designation Order, ¶ 29.

The Bureau also notes that, "[t]he record concerning double counting in the GNP-PI has been enhanced by a second study." Id. Rochester will, therefore, address this issue only tangentially.

if investors anticipated that regulated companies would not be permitted to reflect such expenses in rates when they implemented SFAS 106. That assumption, however, has no basis in fact.

Second, there is no reason to believe that the anticipation of SFAS 106 had any effect on the studies underlying the productivity offsets. Although companies began establishing Voluntary Employee Benefits Association ("VEBA") trusts prior to the implementation of price cap regulation, relatively few companies did so and the amounts involved were relatively small in comparison to exchange carriers' total expenses. Thus, any such effect would have been relatively minor.

Third, there is no basis for concluding that any intertemporal double-counting will occur. Both cash and accrual accounting will, over time, provide revenues sufficient to permit a regulated company to recover its expense for other post-employment benefits ("OPEBs"). However, SFAS 106 alters the timing of when companies must recognize this expense. By according exogenous treatment to the implementation of SFAS 106, the Commission will avoid a timing mismatch between when expenses must be recognized and when revenues are received. The Commission may alleviate any concern regarding a potential double-count by requiring a negative exogenous adjustment at the expiration of the amortization of the TBO.

The Commission permitted exchange carriers to reallocate GSF costs by eliminating the exclusion of Category 1.3 central office equipment investment and expense from those GSF costs that are allocated to the common line basket.<sup>6/</sup> In this proceeding, the Commission has required exchange carriers to demonstrate that they have properly reallocated these costs.<sup>7/</sup> The reallocation was essentially a mechanical exercise. One category of costs formerly was not allocated to the common line basket; now it is. Rochester correctly performed the

the implementation of SFAS 106 qualifies for exogenous treatment. It reached this conclusion on essentially two broad grounds: (a) post-retirement health care costs are within exchange carriers' control;<sup>2/</sup> and (b) the implementation of SFAS 106 neither uniquely nor disproportionately affected

exchange carriers. 10/ In the Designation Order, the Commission



A. The Implementation of SFAS 106  
Was Beyond the Control of  
Exchange Carriers.

The Commission concluded that the implementation of SFAS 106 did not qualify for exogenous treatment because exchange carriers are able to control retiree health care costs.<sup>12/</sup> As Rochester has previously demonstrated,<sup>13/</sup> the Commission asked the wrong question. Rochester, for one, has never disputed that it could -- and does -- exercise control over its retiree health care costs.<sup>14/</sup> However, the question that the Commission should have asked is whether exchange carriers had control over the accounting change from cash to accrual accounting embodied in SFAS 106. The answer to that question is negative.

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<sup>12/</sup> SFAS 106 Order, 8 FCC Rcd. at 1033, ¶ 53-54.

<sup>13/</sup> Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Post-Retirement Benefits Other Than Pensions," CC Dkt. 92-101, Rebuttal to Oppositions to Direct Case of Rochester Telephone Corporation at 9 (July 30, 1992) ("Rochester SFAS 106 Rebuttal"); Rochester Telephone Corp., Tariff F.C.C. No. 1, Trans. No. 187, Description & Justification ("Rochester 187 D & J") at 1-9 - 1-10 (April 2, 1993).

<sup>14/</sup> Thus, although Rochester is providing the materials that the Commission requested regarding its retiree benefit plans, it believes that these materials are irrelevant to the issue of whether the implementation of SFAS 106 qualifies for exogenous treatment.

As Rochester has shown,<sup>15/</sup> although the implementation of SFAS 106 did not affect Rochester's economic costs of providing service, it dramatically altered the timing of when Rochester must recognize those costs for financial reporting purposes. This effect is critical in a rate-regulated industry. Firms that are not rate regulated are free to establish the prices for their goods and services based upon their economic, not their accounting, costs. Thus, because accrued OPEB expense represents a current cost of doing business -- i.e., an economic cost -- firms that are not rate-regulated have already reflected the true economic costs of OPEBs in their prices.<sup>16/</sup>

On the other hand, firms that are rate-regulated have not had that opportunity. Traditional cost of service regulation generally requires that rate-regulated firms establish rates based upon historical accounting costs. Prior to the adoption of SFAS 106, OPEB expense was accounted for on a cash basis. Because the cash method of accounting for OPEBs understates the economic costs of providing OPEBs, rate-regulated firms have not been fully able to reflect the economic costs of OPEBs in

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<sup>15/</sup> Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Post-Retirement Benefits Other Than Pensions," CC Dkt 92-101, Direct Case of Rochester Telephone Corporation at 13-16 (May 29, 1992) ("Rochester SFAS 106 Direct Case"); Rochester SFAS 106 Rebuttal Case at 9-10.

<sup>16/</sup> E.g., Rochester SFAS 106 Rebuttal Case at 13-15.

their rates.<sup>17/</sup> On this basis, recognizing the one-time accounting change as exogenous will merely permit price cap

~~enhance services to achieve parity with their unregulated~~

double-counting.<sup>20/</sup> These concerns lack any factual basis.

1. The Currently Authorized Rate of Return Was Unaffected by the Pendency of SFAS 106.

The Bureau has expressed concern that, when the Commission prescribed the currently authorized rate of return of 11.25%, the implementation of SFAS 106 was a known event. The Bureau posits that the implementation of SFAS 106 was fully reflected in exchange carriers' stock prices and, therefore, was fully reflected in the authorized rate of return.<sup>21/</sup> This argument is both empirically and logically flawed.

The argument assumes that investors would have discounted exchange carriers' stock in anticipation of SFAS 106. The only

reason investors would have done so, however, is if they

in GNP-PI.<sup>22/</sup> In addition, a few companies had begun to establish VEBA trusts and other vehicles to fund their OPEB liabilities and the Commission permitted the recognition of these costs -- which are directly related to SFAS 106 -- in rates.<sup>23/</sup> In these circumstances, it strains credulity to believe that investors would have discounted the price of exchange carriers' stock in the expectation that the Commission would decline to permit such companies to recover their

into account the inclusion of the costs of VEBA trusts and like vehicles, the cost studies may have understated the required productivity offsets.<sup>25/</sup>

The empirical flaw in the Commission's analysis is that relatively few companies subject to the Commission's jurisdiction had begun to establish or fund VEBA trusts during the periods covered by the studies. Moreover, those that established such funding vehicles did so only at the tail end of the periods covered by the studies, both of which ended in 1990. A review of the Annual Access Tariff Filing orders indicates that no companies claimed such expenses in the 1988 or 1989 filings and that only a few did so in the 1990 filing.<sup>26/</sup> Thus, at most, data affecting only a few Tier 1 carriers -- and which affected a relatively small portion of their total expenses<sup>27/</sup> -- would have been altered and that the adjustment the Commission postulates would have only affected one data point in either study. The possibility that excluding such costs from the studies would have had more than a de

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<sup>25/</sup> Id., ¶ 72 & n.117.

<sup>26/</sup> Annual 1990 Access Tariff Filings, CC Dkt. 90-320, Memorandum Opinion and Order, 5 FCC Rcd. 4177, 4211-12, ¶¶ 299-310 (Com. Car. Bur. 1990).

<sup>27/</sup> Compare id., Chart VEBA (showing total VEBA expense subject to separations of approximately \$492 million) with id., ¶ 4 (showing \$696 million in disallowances, or 3.6% of total interstate revenue requirement).

minimis effect on their outcome is pure speculation.<sup>28/</sup> Thus, there is no basis for concluding that, had the Commission made the posited adjustments in the studies, the results would have changed in any material respect.

3. Intertemporal Double-Counting Is Illusory.

The Bureau also suggests that according exogenous treatment to the implementation of SFAS 106 would result in an intertemporal double-count. It posits that, because the

require continuous negative exogenous adjustments<sup>30/</sup> is incorrect. Recognition of the TBO and related accrued interest expense would require only one offsetting adjustment.<sup>31/</sup>

The alleged sources of double-counting suggested in the Designation Order provide no basis for the denial of exogenous treatment of the TBO and related accrued interest expense.

II. ROCHESTER PROPERLY REALLOCATED  
ITS GSF COSTS.

The Commission permitted exchange carriers to reallocate their GSF costs among the price cap baskets by eliminating the exclusion of Category 1.3 central office equipment costs from the allocation to the common line category.<sup>32/</sup> In the Designation Order, the Commission has designated for

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<sup>30/</sup> SFAS 106 Order, 8 FCC Rcd at 1035-36, ¶ 69.

<sup>31/</sup> The Bureau also suggests that exchange carriers' estimates of the size of their respective TBOs are



investigation the manner in which exchange carriers performed this reallocation.<sup>33/</sup>

In its Transmittal No. 196 effecting the reallocation,<sup>34/</sup> Rochester fully explained that the manner in which it reallocated its GSF costs complied with the GSF Order. The exercise was essentially a mechanical one. Certain costs that formerly were not allocated to the common line basket are now so allocated. The result of this change was to increase the allocation of GSF costs to the common line basket while reducing their allocation to the traffic sensitive switched and special access baskets.<sup>35/</sup> Moreover, to Rochester's knowledge, no party has petitioned against Rochester's Transmittal No 196.

The Commission should conclude that Rochester properly reallocated its GSF costs.<sup>36/</sup>

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<sup>33/</sup> Designation Order, ¶ 104.

<sup>34/</sup> Rochester Telephone Corp. Tariff FCC No. 1, Trans. No. 196, Description & Justification at 1-2 (June 17, 1993).

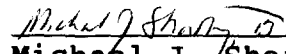
<sup>35/</sup> Id. at 1.

<sup>36/</sup> In addition, on July 16, 1993, Rochester further refined its allocations to take into account the Commission's order addressing the special access expanded interconnection tariffs. See Rochester Telephone Corp., Tariff F.C.C. No. 1, Trans No. 201 (July 16, 1993). As Rochester demonstrated in that Transmittal (id., Description & Justification at 1, Ex. 1), Rochester also properly reflected that reallocation. However, because that Transmittal is not part of this investigation, Rochester will await petitions against that Transmittal -- which Rochester does not anticipate -- before specifically addressing any issues regarding it.

Conclusion

For the foregoing reasons, the Commission should conclude that Rochester: (a) has demonstrated that the TBO and related accrued interest expense qualify for exogenous treatment under the price cap rules; and (b) has properly reallocated its GSF costs.

Respectfully submitted,

  
Michael J. Shortley, III

Attorney for Rochester  
Telephone Corporation

180 South Clinton Avenue  
Rochester, New York 14646  
(716) 777-1028

July 26, 1993

(2588K)

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**Attachment A**

TABLE 1  
 ROCHESTER TELEPHONE COMPANY  
 REGULATED MANAGEMENT AND NON-MANAGEMENT  
 POSTRETIREMENT WELFARE BENEFITS VALUATION  
 AS OF JANUARY 1, 1992  
 (Amounts in Thousands)

	<u>Medical Insurance</u>	<u>Part B Premiums</u>	<u>Reimbursement Account</u>	<u>Life Insurance</u>	<u>Telephone Discount</u>	<u>Grand Total</u>
<b>Accumulated Postretirement Benefit Obligation @ 1/1/93</b>	\$64,979	\$11,624	\$1,883	\$10,693	\$4,415	\$93,593
<b>Annual Expense for 1993</b>						
Service Cost	\$1,111	\$64	\$12	\$180	\$54	\$1,422
Interest Cost	4,957	882	140	813	335	7,128
Amortization of Transition Obligation	3,249	581	94	337	221	4,482
Expected Return on Plan Assets	0	0	0	(379)	0	(379)
Net Periodic Expense	<u>\$9,318</u>	<u>\$1,528</u>	<u>\$246</u>	<u>\$952</u>	<u>\$609</u>	<u>\$12,652</u>
<b>Pay-As-You-Go Expense</b>	\$2,066	\$483	\$154	\$0 \$406	\$200	\$2,903

Notes:

1. Projections reflect "1993 Cost-sharing" retiree medical program.
2. Projections assume a constant active workforce and no actuarial gains or losses.
3. Projections assume that the 1/1/93 retiree life reserve equals \$3,943,904 at Rochester Telephone Company.
4. Expected Return on Plan assets equals 1992 expected benefit payments.
5. Discount Rate = 7.75% per annum.
6. Projections assume adoption of FAS 106 in 1993 and amortization of the Transition Obligation over 20 years.

11-Dec-92

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TABLE 2  
 ROCHESTER TELEPHONE COMPANY  
 REGULATED MANAGEMENT AND NON-MANAGEMENT  
 POSTRETIREMENT WELFARE BENEFITS VALUATION  
 AS OF JANUARY 1, 1992  
 (Amounts in Thousands)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
<b>Accumulated Postretirement Benefit Obligation – BOY</b>	\$93,593	\$98,832	\$104,106	\$109,401	\$114,788
<b>Annual Expense for FY</b>					
Service Cost	\$1,422	\$1,524	\$1,633	\$1,749	\$1,872
Interest Cost	7,128	7,516	7,907	8,301	8,703
Amortization of Transition Obligation	4,482	4,482	4,482	4,482	4,482
Expected Return on Plan Assets	(379)	(379)	(379)	(379)	(379)
Net Periodic Expense	<u>\$12,652</u>	<u>\$13,144</u>	<u>\$13,643</u>	<u>\$14,153</u>	<u>\$14,678</u>
<b>Pay-As-You-Go Expense</b>	\$2,903	\$3,329	\$3,772	\$4,155	\$4,530

Notes:

1. Projections reflect "1993 Cost-sharing" retiree medical program.
2. Projections assume a constant active workforce and no actuarial gains or losses.
3. Projections assume that the 1/1/93 retiree life reserve equals \$3,943,904 at Rochester Telephone Company.
4. Expected Return on Plan assets equals 1992 expected benefit payments.
5. Discount Rate = 7.75% per annum.
6. Projections assume adoption of FAS 106 in 1993 and amortization of the Transition Obligation over 20 years.

11-Dec-92

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## **APPENDIX A**

### **ROCHESTER TELEPHONE CORPORATION POSTRETIREMENT WELFARE BENEFITS VALUATION PREPARED AS OF JANUARY 1, 1992**

#### **OUTLINE OF ACTUARIAL ASSUMPTIONS AND METHODS**

**ACTUARIAL COST METHOD:** Projected unit credit with benefits attributed ratably to service from date of hire until date of full eligibility for benefits. This is the attribution method specified in FAS 106.

**DISCOUNT RATE:** 7.75% per annum, compounded annually.

**MEDICAL PLAN COSTS:** The valuation assumed the 1992 total monthly per capita costs for covered individuals as outlined in Appendix B.

**MEDICARE COORDINATION:** Medicare was assumed to remain the primary payor of benefits for retirees and spouses over age 65.

**TELEPHONE DISCOUNT:** The cost of telephone discount benefits was included for retirees living outside the local service area. The 1992 monthly costs were assumed as outlined in Appendix B. Unless otherwise indicated, the telephone discount was assumed to grow at a rate of 5% per annum (assumed increase in the cost of living) and 35% of current and future retirees were assumed to live outside the local service area.

**ADMINISTRATIVE EXPENSES:** Expenses were assumed to be included in the medical plan costs. No other administrative expenses were explicitly identified.

**MEDICARE PART B PREMIUMS:** As indicated in Appendix B, the Company reimburses retirees and spouses the cost of Medicare Part B premiums. Unless the benefit is frozen, the valuation reflects the following schedule of Part B premium increases for 1992 through 1995 and 5% annual increases thereafter. For years after 1995, we assumed a 5% increase per year.

<u>Year</u>	<u>Premium</u>
1992	\$31.80
1993	36.60
1994	41.40
1995	46.10

**MEDICAL TREND:** Medical plan costs were assumed to increase by the following percentages each year:

<u>Year</u>	<u>Medical Trend</u>
1992	13.0%
1993	12.4
1994	11.8
1995	11.2
1996	10.7
1997	10.2
1998	9.7
1999	9.2
2000	8.8
2001	8.4
2002	8.0
2003	7.6
2004	7.2
2005	6.9
2006 and after	6.8

**DEDUCTIBLE LEVERAGING:** Benefit costs will increase faster than the medical trend rates above due to the erosion of fixed dollar deductibles. Our valuation assumed that the effect of deductible leveraging will increase the 1992 medical trend by 0.73%. It was assumed that this leveraging effect will decrease geometrically by 10% each year.

**SPOUSES WITH MEDICAL COVERAGE:** For current retirees of Rochester Telephone Company, representative values of the percentage of retirees assumed to have covered spouses are as follows:

<u>Age</u>	<u>Male Retirees</u>	<u>Female Retirees</u>
55	83%	60%
60	84	49
65	86	36
70	81	27
75	75	16
80	66	8
85	53	5
90	37	3
95	14	1

**ELECTIONS:** Reported census data was used to identify current retirees with welfare benefits.

**SALARY INCREASES:** Representative values of the assumed annual rates of future increase are as follows:

<u>Age</u>	<u>Annual Rates of Salary Increase</u>
25	8.2%
30	6.2
35	6.1
40	6.0
45	6.0
50	5.9
55	5.9
60	5.9
65	5.8
69	5.8

**DEATHS AFTER RETIREMENT:** According to the 1984 George B. Buck Mortality Tables for men and women.

**NORMAL RETIREMENT:** Age 70.

**ASSETS:** For accounting purposes, we assumed that Rochester Telephone Company has a retiree life insurance reserve of \$3,943,904 as of January 1, 1992 and that the net investment return of Rochester Telephone Company's retiree life insurance reserve was assumed to be 1992 expected benefit payments.

**MISCELLANEOUS:** The valuation was prepared on an ongoing-plan basis. This assumption does not necessarily imply that an obligation to continue the plan actually exists.



**SEPARATIONS FROM ACTIVE SERVICE:** The following tables show representative values of the assumed annual rates of termination, disability, death and retirement prior to normal retirement.

<u>Annual Rate of</u>					
<u>Age</u>	<u>Non-Vested Withdrawal*</u>	<u>Vested Withdrawal**</u>	<u>Retirement</u>	<u>Death</u>	<u>Disability</u>
<u>Men</u>					
25	13.0%	11.0%	—	.1%	.1%
30	10.0	10.0	—	.1	.1
35	10.0	5.0	—	.1	.1
40	10.0	1.0	—	.2	.2
45	5.0	1.0	2.0	.2	.4
50	1.0	1.0	%	.3	.7
55	1.0	1.0	3.0	.5	1.3
60	1.0	1.0	4.0	1.0	1.8
64	1.0	1.0	10.0	1.6	2.0
65	1.0	1.0	30.0	1.8	3.7
69	1.0	1.0	75.0	2.8	
			30.0		
<u>Women</u>					
25	10.0%	10.0%	—	.03%	.1%
30	8.0	5.0	—	.04	.1
35	7.0	3.0	—	.05	.1
40	5.0	2.0	—	.07	.1
45	3.0	1.0	2.0%	.10	.2
50	2.0	1.0	4.0	.16	.4
55	2.0	1.0	5.0	.29	.7
60	2.0	1.0	9.0	.54	1.3
64	2.0	1.0	30.0	.88	1.8
65	2.0	1.0	75.0	.99	2.0
69	2.0	1.0	30.0	1.6	3.7

\*For first 5 years of service

\*\*After first 5 years of service